**Statement by Francis X. Cavanaugh**
**Before the Subcommittee on Domestic Monetary Policy,**
**Technology, and Economic Growth of the**
**Committee on Financial Services**
**U.S. House of Representatives**
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## Administrative Feasibility of Social Security Individual Accounts

Madam Chairman and members of the subcommittee:

I welcome this opportunity to discuss the important subject of establishing individual retirement accounts in the Social Security system.

I am a public finance consultant, but I speak only for myself. I have no clients with an interest in Social Security individual accounts. From 1986 until 1994, I was the first Executive Director, and thus the chief executive officer, of the Federal Retirement Thrift Investment Board, the agency that administers the Thrift Savings Plan (TSP) for federal employees. Before that I was a financial economist in the Treasury Department for 32 years, and was the senior career executive responsible for developing federal borrowing, lending and investment policies, including those for the Social Security and other federal trust funds.

My comments will focus on the administrative considerations in establishing and maintaining a system of individual accounts.

### The Administration's Proposal

While there is no specific proposal before your committee, the Administration's current broad proposal, according to White House statements and press reports, provides a basis for at least a preliminary analysis of its feasibility.

The following features of the Administration's approach would have significant impacts on its feasibility:

– Social Security individual accounts (IAs) would be voluntary for all Social Security taxpayers under age 55, but would be mandatory for employers of employees who chose IAs.

– A major purpose of IAs would be to encourage savings by young and low-income workers and employees of small businesses that do not now have 401(k)s or other pension plans.

– The maximum amount of an individual's initial annual contribution to an IA would be $1,000, which would increase by $100 a year, to 4 percent of pay eventually. It would take more than 30 years for the highest income individuals to be able to contribute the full 4 percent of pay.

– Eligible investments for IAs would be Treasury securities and stock and bond index funds, which would be similar to eligible investments of the federal Thrift Savings Plan.

– IAs would be centrally managed, apparently by a TSP-like agency with a part-time board, appointed by the President with the advice and consent of the Senate, and a full-time executive director and CEO appointed by the board. Following the TSP model, the board members and the executive director would be independent of the Administration, and would be fiduciaries required to act solely in the interests of the holders of the IAs and their beneficiaries.

– Unlike contributions to 401(k)s or to the TSP, IA contributions would not be eligible for matching contributions or exclusion from taxable income, and loans or withdrawals before retirement would not be permitted.

**Cost Analysis**

A critical question, of course, is costs. IAs are proposed to provide a higher investment return than would be realized by the Social Security trust fund. Thus IAs would not be feasible if their administrative costs were so high as to offset the advantage of diversified investments in stocks and other securities that yield more than the Treasury securities in the Social Security trust fund.

The Administration assumes that IAs would earn an average investment return of 4.9% after inflation, and that administrative costs of .3%, that is, 30 basis points, would reduce the net return to 4.6%, or 1.6% more than the assumed net return of 3% on the Treasury securities in the Social Security trust fund. Thus, if one accepts the Administration's assumptions, IAs would outperform the trust fund investments so long as the administrative costs were less than 1.9%. In my view and that of many other economists, the 4.6% assumption is much too high; indeed, the Congressional Budget Office's estimate of the net return is reportedly only 3.3%.

The Administration's estimate of 30 basis points is optimistically low; even the Cato Institute, a leading advocate of individual accounts, estimates IA expenses at 55 basis points. Yet this higher estimate is also too low. Like so many others I have heard, these estimates are based mainly on experience with large 401(k)s for large organizations, like the TSP,[1] with economies of scale and comprehensive payroll, personnel, and computerized systems support. They have little relevance to the likely costs of a universal system of IAs. More than 85 percent

[1] The administrative cost, or expense ratio, of the TSP is 6 basis points.

of the 5.6 million small business employers in this country offer no pension plans at all and, accordingly, have *none* of the administrative apparatus to service them.

To understand the costs of bringing IAs to employees of small businesses, we must first understand why 85 percent of them do not now have retirement plans for their employees. Fortunately, the 401(k) industry has already done part of the job for us. Companies like Citigroup, Fidelity Investments, Merrill Lynch, State Street Corporation, and T. Rowe Price have been competing for two decades to provide investment, record keeping, counseling, and other 401(k) plan services to small businesses. They have found that they cannot profitably provide these services for a company for less than approximately $3,000 a year, even though they have for years enjoyed economies of scale from serving thousands of employers in their centralized computer systems.[2] Further significant economies of scale would not be realized by a central TSP-type agency, because there would still be millions of small businesses or workplaces to be reached. Nor can we assume that a new central government agency would be more efficient than the major 401(k) providers who now serve this market.

Thus the cost per employee of a company with 10 employees would be $300, or 30 percent of the President's proposed annual IA contribution of $1,000 – and most U.S. companies have fewer than 10 employees.[3]

Even the largest business that is classified as a "small business," one with 100 employees, would therefore have an expense ratio of at least 3 percent, which would be ten times the Administration's estimate of 30 basis points. And for the 60 percent of employers in this country that have fewer than 5 employees, the initial expense ratio would be more than 60 percent, that is, 6,000 basis points. In fact, commercial 401(k) providers routinely discourage small businesses from establishing 401(k) plans if they have fewer than 10 employees and, in some cases, fewer than 25 employees.

Obviously, substantial and continuing government subsidies would be necessary to make IAs attractive to employees of small businesses. If all Social Security taxpayers participated in the IA program, the administrative costs would be more than $46 billion a year (155 million participants times more than $300 per account), which would be a subsidy to IA administrators for

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[2] Francis X. Cavanaugh, "Feasibility of Social Security Individual Accounts," AARP Public Policy Institute, Washington, D.C., Sept. 2002, pp. 4-6. The $3,000 charge is still common today. *See* "Big Fees Hit Small Plans: Costs Take Huge Toll on Retirement Accounts of Firms With Fewer Than 50 Employees," Wall Street Journal, Oct. 31, 2004, p. D1.

[3] *See generally* U.S. Department of Labor, Pension and Welfare Benefits Administration, "Study of 401(k) Fees and Expenses,"Apr. 13 ,1998. The study found that average charges by 17 major 401(k) providers for plans with 100 participants and $2 million in assets ranged from $114 to $428 per participant, and averaged $264. *Id.* at 51. Charges obviously would be much higher for much smaller plans.

performing an uneconomic function. These figures are reinforced by a number of studies, including those cited in a review of administrative costs by the Employee Benefit Research Institute.[4]

I recommend that your committee secure the testimony of individuals from financial institutions that are actually providing 401(k) services to the nation's businesses, large and small. Give them a specific set of assumptions to cost out that reflects the makeup of our country's 5.7 million employers subject to Social Security – of which 98% are small business employers of 68 million employees.[5] Then and only then will you know whether the Administration's proposal – or anything similar – will produce reasonable net investment returns, or, in the alternative, how much of a government subsidy would be necessary to achieve them.

**Critical Administrative Problems**

In addition to the above costs, which are based on what the current providers are actually charging for establishing and servicing 401(k) plans, there are overwhelming practical obstacles to the creation and maintenance of IAs. Because President Bush seemed to idealize the Thrift Savings Plan – the largest of all 401(k)-type plans – as the model for IAs in his February 2005 State of the Union message – and because many others have done so as well – I would like to point out the considerable dissimilarities between the TSP and the Administration's proposal. (Most of these dissimilarities would hold true for a comparison between any large corporate 401(k) plan and the proposal.)

**Too Many Small Employers.** The TSP is administered by just one employer – the U.S. Government – with extensive personnel, payroll, and systems staffs to provide the essential employee education, retirement counseling, payroll deduction, timely funds transfers, and error correction functions. The Thrift Investment Board is only a wholesaler of services; the federal employing agencies deal with the individual employees participating in the plan. In fact, the TSP statute directs the Office of Personnel Management to provide for the training of TSP counselors for each federal agency.

The Administration's plan is intended to reach all employees, but it makes no provision for the performance of what are now essential employer functions in 401(k) plans. They could not possibly be performed by small business employers who are now responsible only for the relatively simple payroll deduction and transmission of Social Security taxes to the IRS. Since most businesses have fewer than ten employees, they do not have the experience or administrative resources to support the new plan. These are barbershops, beauty salons, garages, restaurants, laundries, lawn services, households, nanny services, and other very small businesses that

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[4] *See, e.g.*, Employee Benefit Research Institute, Issue Brief No. 23, Nov. 1998. *See also* Ellen E. Schultz, "Poodle Parlor Retirement Plans," Wall Street Journal, Nov. 13, 1998, p. C1.

[5] Patrick Purcell, Congressional Research Service, "Social Security Individual Accounts and Employer-Sponsored Pensions," Feb. 3, 2005, pp. 3, 5.

could not be expected to meet the high fiduciary standards required of those responsible for educating and counseling employees, for presenting a new plan in the context of the employer's existing pension or other benefits, and for the timely and accurate transfer of funds for investment. The new TSP-like agency obviously could not provide such employer-type services to deal with tens of millions of diverse employees, either directly or on a contract basis.

Consider, as but one example of several profound administrative and legal issues, that about 650,000 businesses go out of business *each year*. By whom and how would the enforcement of contributions by delinquent or bankrupt employers be prosecuted? (Judicial remedies for denial of TSP benefits must, in general, be pursued by the affected individual TSP participant in the federal court system.) For that matter, by whom and how would breach-of-fiduciary-duty suits be brought against "mom-and-pop" fiduciaries? Can the employer of a housekeeper or a manicurist be expected to exercise the "care, skill, diligence, and prudence" demanded of every 401(k) plan fiduciary by current law? What would be the measure – and the limit – of their personal liabilities, say, for untimely or inaccurate investment of their employees' contributions? These questions only scratch the surface of the inevitable pathology of plan administration – pathology that, even if represented in small percentages among 155 million Social Security participants, would result in enormous absolute numbers.

**Untimely Investments.** The TSP is computerized, like all other large plans, with investments made for each employee's account on the same day that contributions are deducted from the employee's paycheck. Social Security taxes are deducted on paydays, but many small businesses send them to the IRS once each quarter. In 2003, 72 percent of employer reports to the Social Security Administration were submitted *on paper*. Moreover, individual Social Security taxpayers are identified only once each year, with their employer's annual income tax filings; and it would be up to 22 months after payday, under current SSA procedures, before individual IAs could be credited.

Furthermore, the Administration's proposal is to pay IAs the same annual return, regardless of when contributions were actually made during the year. Thus a contribution in January would not earn any more than a contribution of a similar amount in December. During a year of highly volatile markets, the attempted explanation of this provision to millions of outraged participants with irregular tax payments, because of illness, seasonal, temporary, or other periods of unemployment, would be a daunting challenge to the plan's telephone counselors.

**Unbalanced Accounts.** The TSP is balanced to the penny every day. The Social Security system is never balanced. Each year there are billions of dollars of unreconciled discrepancies between Social Security taxes paid to the IRS and reported to the SSA. These discrepancies are tolerated because they generally have little impact on the ultimate calculation of employee benefits. Such discrepancies are never tolerated by financial institutions responsible for timely investment of individual funds. Theoretically, IA contribution errors might be largely corrected by a rigorous examination of employer records. Yet the error correction procedures, including retroactive adjustments of investment gains or losses in volatile markets, could bring the entire system to a screeching halt.

**Inevitable Account "Leakage."** Unlike the TSP, the Administration's plan would prohibit loans and emergency withdrawals, and would require individuals to purchase annuities on retirement. I find it inconceivable, however, that Congress – or an Administration – would long be able to resist calls for emergency access to funds before a worker's retirement, and in lump sum amounts. Suppose, for example, that an individual has suffered a devastating personal financial loss, such as thousands experienced in last year's Florida hurricanes in the destruction of their homes. Would these persons be told that they may not access their IA balances to mitigate such dire misfortunes? What about a catastrophic illness, leaving a family's breadwinner unable to work? Could such persons be denied their account balances to sustain spouse and children? I don't think so. There are, of course, scores more such examples, and with 155 million potential participants, you can be sure that they all would arise. Administering the inevitable emergency withdrawal or loan program would add enormously to the cost of the Administration's plan.

**Communication Problems.** The TSP has a very effective communications system, because it can rely on the federal employing agencies to distribute plan materials and to educate and counsel their employees. Even so, the TSP found it necessary to have the central record keeper for its 3 million accounts maintain a staff of more than 200 telephone counselors to respond directly to questions from individual participants. Since more than 200 million Social Security taxpayers and retirees eventually would be eligible for IAs, the required number of telephone counselors would be more than 13,000, based on the TSP experience, and probably much higher because of the special IA deficiencies noted above.[6] Also, TSP mailings consistently have reached more than 99 percent of participants, but 25 percent of SSA mailings are returned as undeliverable.

Congress would undoubtedly insist that every effort be made to advise all Social Security taxpayers of the IA benefits Congress intended to provide them. The TSP sent summary plan documents to all 3 million eligible employees, which required 18 trailer trucks of printed materials. Similar documents would have to be sent eventually to the more than 200 million Social Security-covered employees and retirees.

The eventual costs of such massive efforts at this point are unknown, but they clearly would have a significant impact on IA expenses.

**Small Employer Antipathy.** Even if small businesses were able to perform normal employer functions for IAs, would they want to? IAs would be voluntary for employees but, if employees elect to have IAs, mandatory for their employers.

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[6] Fidelity Investments, a major 401(k) provider, has estimated that the administration of a 401(k)-type plan for Social Security taxpayers would require a total staff of 100,000. *See* Employee Benefit Research Institute, Issue Brief No. 23, Nov. 1998, p. 166.

The TSP and 401(k) plans generally are enthusiastically sponsored and supported by the large employers who offer them as a major benefit for their employees, and as a means to move away from defined benefit retirement plans that require employers to bear substantial investment risks. The major attractions of the TSP and 401(k)s generally are the matching employer contributions and the immediate tax benefit from excluding employee contributions from taxable income. The ability to borrow or withdraw funds to meet emergency needs is also a significant benefit. IAs, as currently proposed, would offer none of these benefits, and would be a relatively unattractive product that employers might be reluctant to support, especially small employers who do not have any pension plans. Moreover, it would be unrealistic to expect small-business employers to act as large corporate employers do in assuming the costs of investment losses because of, say, employer error in transmitting funds for timely investment of 401(k) accounts, or for myriad other commonplace employer errors. These serious concerns for small businesses would have to be addressed during congressional hearings on IA proposals. (See the examples of legal issues on page 5 above.)

**The Trust Fund Alternative**

Since IAs are certainly not feasible for employees of small businesses – the vast preponderance of the business community – the only practical way to give them the higher returns available from equity investments is to invest part of the Social Security trust fund in equities. That way, the overwhelming administrative costs and practical problems of the Administration's plan would be avoided. The total administrative cost of having the Social Security trust fund invest in the private funds proposed for IAs would be no more than one basis point, based on the actual costs of market investments by the Thrift Savings Plan. The likely increase in trust fund earnings would be an effective way to help maintain the solvency of the trust fund without having to resort to significant increases in Social Security taxes or reductions in benefits.

Every state in the United States has authorized public retirement fund investment in stocks. Yet the federal government still clings to the old notion that governments should not have an ownership stake in private companies, which made some sense when individual stocks were involved. Today's broad based index funds, however, remove the investor from direct control over particular companies. Small business employees should not be denied the benefits of portfolio diversification in the Social Security trust fund simply because the federal government has not kept up with the states in understanding the evolution of financial markets.

**Less Government Influence Over Private Companies.** As shown in the following chart, there is even less government influence over private companies under the trust fund alternative than under the TSP or the Administration's plan.

Government Influence Over Private Companies

| | Thrift Savings Plan | Administration Plan | Social Security Trust Fund Alternative |
|---|---|---|---|
| Selection of stock and bond index funds | Government decides | Same | Same |
| Selection of fund managers | Government decides | Same | Same |
| Selection of private record keeper | Government decides | Same | N/A |
| Selection of auditors and consultants | Government decides | Same | N/A |
| Selection of annuity providers | Government decides | Same | N/A |
| Selection of allocations among index funds | Individuals decide | Individuals decide | Government decides |

N/A – not applicable. (There would be no need for private record keepers, auditors, consultants, or annuity providers for trust fund investments.)

**Special Benefits for Trust Fund.** Unfortunately, some political leaders have convinced many of the public that the Social Security trust fund is not really invested because it has been "looted," and that the trust fund consists of "worthless IOUs." Nothing could be farther from the truth, and such statements betray an apparent ignorance of federal finance in our highest circles of government. The trust fund is fully invested in the best securities in the world – U.S. Treasury obligations. Private trust funds invest in Treasury securities in the open market, but the Social Security trust fund buys its Treasury securities directly from the Treasury, which is more efficient than if the Treasury were to issue the securities in the market and then buy them back for the trust fund.

Moreover, the trust fund actually gets a much better deal than the private funds that buy Treasuries in the market. The trust fund, by law, may redeem its securities before maturity at par value, rather than at the sometimes deep market discounts suffered by private investors during periods of rising interest rates. Also, since the trust fund gets its securities directly from the Treasury, it avoids the market transaction costs which private investors must pay. Finally, the law requires the Treasury to pay the trust fund an interest rate on all of its investments in Treasuries equal to the average yield on long-term Treasury marketable securities. This is a significant benefit to the trust fund, since long-term rates are generally much higher than short-term rates. Thus in recent years, private investors have been earning about two percent on their short-term Treasuries, while the Social Security trust fund was earning about four percent on effectively the same maturities. The public seems to be totally unaware of these subsidies to the Social Security trust fund, which have been there for many decades.

**Trust Fund Dedicated to Social Security.** The assets of the Social Security trust fund consist of investments in Treasury securities solely for future beneficiaries. Yet political leaders from both parties complain that the Treasury has "spent" the trust fund surplus on government programs. What on earth do they expect the Treasury to do with the money – bury it in the Treasury's back yard? The Treasury also spends the money it raises by issuing Treasury securities in the market. Does that mean that the private investors in Treasuries are also being "looted" by the Treasury? Of course not. The scandal would be if the Treasury left the trust fund uninvested and not earning interest. Then the Secretary of the Treasury would be in effect saying "I *don't* owe you," and that indeed would be a worthless IOU.

So why do government officials find fault with perfectly sound financial practices? From ignorance, as I suggested earlier? – or is it is because they are trying to hide the real problem, which is the unique way this major government program is treated in the budget? Social Security expenditures are excluded from the budget and thus from the restraints on other government spending, which is proper since they are entitlements, and cannot be restrained under existing law. But the Social Security surplus is then, inconsistently, included in the calculation of the overall budget deficit, for the sole purpose of appearing to have achieved deficit, and thus spending, reduction. Then, having committed this accounting farce, officials have the audacity to complain that the misleading budget treatment of the trust fund surplus makes it available to finance other programs. The problem here is not the financing of the trust fund, but the political gimmickry of its budget treatment.

**Conclusion**

In conclusion, the Administration's plan for universal IAs is not feasible, and it should not survive the process of responsible Congressional hearings. The only practical way for the Social Security system to capture the higher returns available from investments in stocks is to diversify Social Security trust fund investments. The trust fund alternative, compared to IAs, would involve less government influence over private companies, would be less disruptive of financial markets, would save tens of billions of dollars a year in administrative costs, and could be effective virtually immediately, rather than the 2009 starting date proposed for IAs. The multi-trillion dollar transition costs proposed by IA proponents would be avoided. The additional trust fund earnings would go a long way toward strengthening Social Security finances, and would thus reduce, if not eliminate, the need for significant tax increases or benefit reductions.

Thank you for your attention. I would be pleased to answer any questions.